TUNING IN TO THE BANK RECAPITALIZATION PLAN

by Steve Brown

Before cable television existed, people would sometimes tune to their favorite station and see the screen at the left. It told them their show was off the air, but it gave little in the way of further details. Banking has been like that lately.

Consider the rescue packages announced recently and in particular the bank recapitalization plan. Tons of information has been provided about the plan from the regulatory community, but there are also still lots of unanswered questions. Before we focus on the recapitalization plan today and its impact on community banks, however, consider something. Right now, all over DC, regulatory experts are locked away in dozens of conference rooms working on the details. Lunch is being delivered in, no one is going home, no one is sleeping and no one is showering (ok, we're not sure about that one). We don't ask you to feel sorry for regulators (after all, that would run against the banker creed and code), but we do ask you to be patient (since the details are still evolving). Along those lines, here is what we know so far about the TARP Capital Purchase Plan ("TCPP").

Details: TCPP is open to qualifying institutions (not yet defined) that elect to participate prior to 11/14/08. The minimum a bank can take down is 1% of risk-weighted assets and the maximum is 3%. Funding will be provided by the Treasury by year-end 2008. The shares will qualify as Tier 1 capital, are senior to common stock, will pay a cumulative dividend rate of 5% for the first 5Ys and will reset to 9% after that. The term is perpetual and dividends are payable quarterly in arrears on Feb 15, May 15, Aug 15 and Nov 15. Dividends cannot be paid on common shares until all dividends on the TCPP have been paid. The shares are non-voting, except in regard to authorizing a more senior class of shares, amendments to rights or mergers that would affect the rights of the shares. If dividends are not paid in full for 6 dividend periods, the TCPP can elect 2 directors to the board. The shares are callable after 3Ys and may be redeemed with proceeds from a qualifying equity offering of any Tier 1 stock (we are still trying to get clarification whether banks could pay this off with earnings). In addition, the Treasury will receive warrants to purchase common stock with a market price equal to 15% of the investment at an exercise price equal to the market price of the bank's stock at the time of issuance (based on a 20 day trailing average). Warrants last for 10Ys and are immediately exercisable (but would be reduced by 50% if the bank raised common equal to the senior shares by 12/31/2009). Banks that participate must also adopt the Treasury's standards for executive compensation and corporate governance (generally applies to the top 5 most highly paid executives). Banks that want to enroll need to contact their primary regulator (but give them a few days, as the application is not yet ready).

Nuances: In regard to executive compensation some banks will need to modify existing benefit plans and agreements. Banks that raise capital using TCPP cannot subsequently use the proceeds to pay off an existing trust-preferred issue. Subchapter S corporations will be eligible, but more details are expected. Privately held banks can also participate but, again, more details are coming in regard to warrant pricing. It is expected that Treasury would approve community banks for the program that have fallen a capital category due to losses on FNMA/FHLMC preferred stock (because excluding that issue, many of these banks had long-term viability). TCPP will not be made available to banks deemed likely to fail (which will be determined by consultation between Treasury and the primary regulator). Finally, banks cannot repurchase stock or increase common dividends, without prior consent.

Our Take: This capital is offered at an after tax cost of 5% for the first 5Ys, which is inexpensive for community banks. In addition, a warrant of 15% is somewhat comparable to the 15% over allotment rights investment banks get on IPOs (note that there are no underwriting fees here). The capital is only minimally dilutive, it could support a substantial increase in EPS for existing common shareholders and it can be retired after 3Ys. It will enhance capital ratios, increase industry consolidation, improve bank liquidity and reduce funding costs. Overall, TCPP gives healthy banks access to inexpensive capital, while providing more breathing room to raise private capital.

Tune in for more in coming days, as we continue to actively flip through the channels and attempt to get a clearer picture for community banks.

BANK NEWS

Earnings

Wells reported 3Q profit fell 24% from last year, as the bank doubled its reserves, charge-offs climbed 2% and falling home prices led some consumers to miss payments. Citi reported its 4th consecutive loss of $2.8B (better than expected), compared to earnings of $2.2B for 4Q 2007. The loss was attributed to $13B in loan and securities write downs.

Credit Cards

The delinquency rate on credit cards jumped 20% in July to 4.52% compared to last year. Meanwhile, debt 90 days or > delinquent reached the highest level since 1991.